FILED
AUG 18 1942
CHARLES ELMORE CROPLEY
CLERK

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 314

LAKESIDE IRRIGATION CO., INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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MASON, SPALDING & MCATEE,
WILLARD SHUART,
Of Counsel.

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COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Above petitioner, by its attorney, respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit in the above entitled cause.

Judgment, Jurisdiction and Opinions Below.

The judgment of the United States Circuit Court of Appeals below was entered May 20, 1942 (R. 68). The petition for certiorari was filed August 18th, 1942, and jurisdiction is invoked pursuant to the provisions of Section 1141 of the Internal Revenue Code, and Section 240

of the Judicial Code, as amended, 43 St. 938 (U. S. C. T. 28, Sec. 347).

The opinion of the Circuit Court of Appeals below appears at R. 65, and the opinion of the United States Board of Tax Appeals at R. 23-34.

Question Presented.

The application of the provision of Section 24(a)(6) of the Revenue Act of 1936, that *"in computing net income no deduction shall in any case be allowed in respect of loss from sales or exchanges of property, directly or indirectly"* between members of a family, or, except in cases of distributions in liquidation, between a corporation and any individual defined as owning more than 50% in value of its outstanding stock:

> (a) as within the intent of Congress in enacting said section;
>
> (b) as requiring the translation of one admitted single transaction into separate transactions for its application;—

where, in one admitted and intended transaction, in 1936, a corporation duly made a naked transfer of four blocks of stock, which it owned in other corporations, to such stockholder, who received them solely as a credit on account, in the lump sum amount of their existing market values, upon a debt long overdue from the corporation to such stockholder; and

Where such corporation realized a small taxable net gain from the transfer represented by the excess of its realized statutory gains on two of the stocks over its realized statutory losses upon the other two stocks.

The decision below increases the realized taxable net gain of $349.50 to $11,525 (with a consequent tax deficiency

of $3,556.22), on the grounds that the transfer was a sale or exchange in which the component losses are disallowed by Section 24(a)(6), and that the realized taxable gain is the sum of the component gains.

Statute Involved.

Revenue Act of 1936 (C. 690, 49 St. 1652):

> "Section 24(a). General Rule.—In computing net income no deduction shall in any case be allowed in respect of: * * *
>
> "(a)(6). Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purpose of this paragraph—(C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."

Statement.

The facts are stipulated and undisputed. They state (R. 20) and the Board (R. 25) found:

> "It was the intention of the Board of Directors to deliver all of these stocks at one time on a certain date, and that Louise Wintermann's account be credited with one lump sum * * *."

The proceeding springs from the denial by the Court below of a petition for review of the previous Board affirmance, of an additional tax of $3,556.22, exclusive of interest, as proposed by respondent against petitioner, for the calendar year 1936.

In April, 1936, petitioner offered (R. 24) either the sales proceeds of four stocks which it owned in other corporations, or said stocks at their current market values as a payment on account of its long overdue debt to its creditor, Mrs. Louise Wintermann. She was the mother of its officers and indirectly the owner of more than 50% of the value of its outstanding stock (R. 15). Upon her election to take the stocks instead of their net cash proceeds, its president duly delivered the stocks at one time as a lump sum credit in the amount of their ascertained market value (R. 25).

On April 26, 1936, the books (R. 26) of petitioner showed its account with her credited with $26,737.50 as the aggregate lump-sum market value of the stocks, their aggregate cost as $26,388, and the petitioner gain from the transfer as $349.50. This net gain of $349.50 was computed (R. 26) by comparison of its market value at transfer with the original cost of each stock, and as the difference between the gains of $11,525 on two of the stocks and the losses of $11,175.50 on the other stocks. Petitioner subsequently in its 1936 tax return (R. 26) computed and tax paid this gain of $349.50.

Respondent, upon review of the return, held Section 24(a)(6) (R. 30) separated the single transfer of the stocks into four alleged sales or exchanges, and held the offset of the losses against the gains was thereby forbidden. This action increased petitioner net income in the amount of $11,175.50 (being the gain of $11,525, less $349.50 reported and tax paid), particularly made subject to an additional tax of $3,318.40, as the proposal of $3,556.22 includes other minor adjustments (R. 9). Upon the petition for redetermination, the Board, although holding the parties intended but one transaction, affirmed its separation into four sales or exchanges for the application of

Section 24(a)(6), but declared such application to the evident bona fide transaction was unduly harsh (R. 33).

The Court below affirmed, again emphasizing the summary and hard application of Section 24(a)(6) by stating the section would not apply if petitioner had sold the stocks and paid the money to the creditor stockholder who then might have bought the same or other stocks with the money (R. 68).

In other words, where the petitioner officers dealt straightforwardly in a closed business deal with their mother, petitioner is assessed over $3,300 in tax only because their mother prudently elected to benefit, from the credit of the market value of the stocks, to the extent of the brokerage fees or expenses payable if petitioner had sold the stocks and paid the money to her, and if she had bought the same or other stocks with the money. However, that the effect of the decision as a precedent will be far more serious as approving the creation of taxable income where no income exists, is the gravamen of this petition.

Specifications of Errors to be Urged.

The Circuit Court of Appeals erred:

I. (a) In holding Congress intended Section 24(a)(6) to apply to the present case.

II. In holding Congress intended the undisputed single transaction to become four separate transactions for the application of Section 24(a)(6).

III. In disregarding and causing conflict with established precedents by its affirmance of the Board.

Reasons for Granting the Writ.

1. The decision below, extending the disallowance of "loss from sales or exchanges of property" to a single

bona fide naked transfer of property as a payment or credit upon a debt, is not justified by the provisions or intent of Section 24(a)(6). The further extension of the Section to disallow the component losses instead of the recognized net loss misconstrues its intent by converting the component gains into taxable income, whether or not they are more or less than the component losses. In other words, the decision below erroneously applies Section 24(a)(6) to a disposal of property beyond its intent, and erroneously creates taxable income where none exists by construing the Section as disallowing either the component or net loss.

2. Unless corrected, the decision below will have burdensome and confusing consequences. Herein, the mere statutory denial of loss—reasonably the net loss recognized in a single transaction—is converted into a penalty. A recognized net gain, to which the Section has no application, is magnified from $349.50 to $11,525—more than thirty times—and taxed more than $3,300. Applied in a later case,[1] the same erroneous construction makes a net loss of $79,481.40, deemed not allowable by taxpayer, into a net taxable gain of $27,500.03. Petitioner seeks to absolve Congress from any intent to authorize this legerdemain that builds synthetic income by disallowance of the component losses and net loss in a single transaction. The decision below extends these fantastic results beyond the "sales or exchanges" defined in the Section to other disposals of property between the specified persons or corporations.

The decision thus conflicts with Section 111, providing in any case of sale or other disposition of property the gain shall be the excess of the amount realized over the adjusted basis provided in Section 113(b) for determining gain, and

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[1] *M. F. Reddington, Inc.*, B. T. A. Memo. Opinion (2/16/42). C. C. H. Dec. 12424-A, pending on review in Second Circuit.

the loss shall be the excess of said adjusted basis over the amount realized, and providing in case of sale or exchange the entire amount of gain or loss, determined under Section 112, shall be recognized. As cost is the admitted basis of these computations herein, this conflict is simplified into the refusal below to recognize realized gain or loss from a single transaction as the net difference between cost and market value, and to apply the Section to disallowance of any net loss. The error of such refusal below has been shown to be the creation of taxable income that is without substance.

3. Petitioner believes the decision of the Court below is manifestly erroneous in its interpretation of the intent and application of Section 24(a)(6), and in its disregard of and conflict with settled precedents.

(a) Enactment of Section 24(a)(6) is said by this Court in *Higgins* v. *Smith*[2] to have followed particularly the acceptance of the decision of *Jones* v. *Commissioner*[3] by other Circuit Courts, and by this Court.[4] The *Higgins* opinion says section 24(a)(6) preserves the separable taxable entities between a taxpayer and a controlled corporation, and may well have been enacted to extend as well as clarify the previous rule against the allowance of loss in unsubstantial transactions between them.

The prior rule, based not on any provision of law or regulation, but upon the inherent duty of respondent to seek substance in pursuing income, is thus further elucidated in the *Higgins* opinion (Op. p. 477):

> "* * * The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the lia-

[2] 308 U. S. 473.

[3] 63 App. D. C. 204; 71 F. (2) 214.

[4] This Court denied certiorari in the Jones case, 293 U. S. 583.

bility of the particular taxpayer to the detriment or advantage of the entire taxpaying group.

"* * * A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.

"On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property."

Under the prior rule, respondent has disregarded or rejected a sham transaction in its entirety, and this Court has frowned upon efforts to resolve a single transaction into elements productive of gain in certain aspects by disregard of loss in other aspects.[5] In other words, substance rather than from controls.[6] Notwithstanding and after its elucidation by this Court, the prior rule has been held inapplicable, in the Fifth Circuit below, to a bona fide sale of property by a son to his father,[7] and, in the Ninth Circuit, the "tax event" to be availed of by the tax collector is held not inclusive of a business transaction with an independent purpose that establishes it is not a transfer

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[5] *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 270; infra notes 22 and 28.

[6] *Weiss* v. *Stern*, 265 U. S. 242, 254.
Gregory v. *Helvering*, 293 U. S. 465, 469-70.
Higgins v. *Smith*, supra.
Regulations 103, Sec. 19, 23(e)-1.

[7] *United States* v. *Spalding*, 115 F. (2) 54 (C. C. A.-5).

of assets made to reduce tax liability while involving retention of their control.[8]

That Congress did not intend the prior rule to be supplanted by Section 24(a)(6) is plainly shown in its subsequent statement in 1937.[9]

> "This provision of existing law is not exclusive, and the government may still deny losses in the case of sales or exchanges not specifically covered thereby (for instance, between uncle and nephew) if such sales and exchanges are not bona fide."

The extent to which Section 24(a)(6) extends and clarifies the previous rule then becomes material. Admitting it precisely extends to loss from sales or exchanges of property between the designated entities in the present case, its phrase "sales or exchanges" is submitted not to embrace the bona fide transfer herein of property in payment or for credit on a bona fide debt. This Court recognizes such naked transfer, as an accord and satisfaction at common law and a *dation en paiement* in the civil law, is, therefore, not a sale nor exchange;[10] it recognizes the payment of a bond is neither a sale or exchange in the ordinary meaning of the words.[11] Hence, the naked transfer of property to pay a debt is neither sale nor exchange.

The plain words of the Section evidence the intent of Congress to confine the disallowance of loss to sales or exchanges. Its legislative history manifests Congress levelled the Section only against such transactions to prevent

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[8] *Commissioner* v. *Laughton*, 113 F. (2) 103 (C. C. A.-9).

[9] Ways and Means Committee Report No. 1546, 75 Cong. 1st Sess. (1937), p. 26. It is to be noted this comment is limited to sales and exchanges.

[10] *Warner* v. *Martin*, 11 How. 209, 226.

[11] *Fairbanks* v. *United States*, 306 U. S. 436, 437.

synthetic formal tax loss deductions.[12] Any extension of the prior rule by the Section to a transaction, not under the *Jones* case or other decisions, and not previously subject to such rule, is submitted to be limited by the statutory phrase: "loss from sales or exchanges of property". The above decisions of the Fifth and Ninth Circuits emphasize these propositions.

Denial of such limitation below is conflict with the settled principles that substance, not form, is the intent ascribed to taxing statutes [13] and their meaning is that commonly given to their words;[14] that such statutes are strictly construed in favor of the taxpayer;[15] that unambiguous words are not construable [16] unless their external application offends the moral sense as injustice, oppression or absurdity or tends to an unreasonable result plainly contrary to the whole statutory intent.[17]

The conflict with other provisions of the Revenue Act as previously stated gives the error and conflict greater reality and points the necessity for correction.

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[12] Preliminary report of Prevention of Tax Avoidance by Sub-committee of Way and Means Committee, 73 Cong. 2nd Sess. (Dec. 14, 1933, pp. 14-15).

Ways and Means Committee Report No. 704, 73 Cong. 2nd Sess. (1934), p. 23.

Senate Finance Committee Report, No. 558, 73 Cong. 2nd Sess. (1934), p. 24.

Chairman of Ways and Means Subcommittee, 78 Cong. Rec., p. 2663.

The legislative history is noted in detail in *Higgins* v. *Smith, supra.*

[13] Note 6, supra.

In a sale of several articles at separate prices in "a single transaction", the application of the Statute of Frauds is determined by their total value. *Garfield* v. *Paris,* 96 U. S. 557; Williston On Sales (1909), pp. 73-75.

[14] *Old Colony Railroad Co.* v. *Commissioner,* 284 U. S. 552.

[15] *McFeely* v. *Commissioner,* 296 U. S. 102, 111.

[16] *Helvering* v. *New York Trust Co.,* 292 U. S. 455, 464.

[17] *Van Camp & Sons Co.* v. *American Can Co.,* 278 U. S. 245, 254.
Church of the Holy Trinity v. *United States,* 143 U. S. 457, 471.
Burnet v. *Chicago Portrait Co.,* 285 U. S. 1, 16.
United States v. *Jackson,* 280 U. S. 183.

The conflict finds neither support nor reason in the citation below of the prior decision of *Burger Phillips Co.* v. *Commissioner.*[18] That is an entirely different case where the rights of the parties against each other in one piece of property placed each within the power of the other, and their sale or exchange of such rights effected new substantial advantages to each of them. To the contrary, petitioner made a naked transfer of property for credit upon its debt, and thereby made no sale or exchange as petitioner received nothing of value in return.

(b) The court below notes no direct authority is cited *"whether for tax purposes what happened is one single or inseparable sale or exchange, or may and must be considered as four"* (R. 67). The authority disregarded, in approving consideration of the transfer as four sales or exchanges, is the admitted fact of one single inseparable transaction.

Because petitioner rightfully viewed the component parts to determine the recognized gain or loss from their single disposal, the consolidation of its component gains and losses and their recognition as a single net gain is rejected. In the *Reddington* case, their consolidation and recognition as a net loss concededly unallowable is again rejected. In both cases, Section 24(a)(6) is held to disallow the component losses and thereby not to recognize for disallowance only a net loss.

The evident error is the placement of form above substance in the application below of Section 24(a)(6) to the transactions, and to create income where none exists. Instead of a mere disallowance, the section is made a heavy penalty, with a net taxable gain of $349.50 herein magnified over thirty-fold to $11,525, with the *Reddington* net loss of $79,481.40 metamorphosed into a taxable gain of

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[18] *Burger-Phillips* v. *Commissioner,* 126 F. (2) 934 (C. C. A.-5).

$27,500.03, and with other synthetic results to be anticipated in subsequent cases.

Petitioner again refers to precedent as justifying its assertion of error and conflict. The administrative rule for the consideration of the exceptions from the recognition of gains or losses in Section 112(b) of the 1934 Act, and Section 112(b)(1) to (5), inclusive, of the 1936 Act, is submitted fully applicable herein, and is stated in Article 112(a)-1 of Regulations 86 and 94 as follows:

> "The exceptions from the general rule requiring the recognition of all gains and losses, *like other exceptions from a rule of taxation of general and uniform application, are strictly construed, and do not extend either beyond the words or the underlying assumptions and purposes of the exception.*" (Italics supplied.)

It is additionally pertinent that Section 112 provides:

> "Upon the sale or exchange of property the entire amount of the gain or loss, determined under Section 111, shall be *recognized* except as hereinafter provided in this Section."

Under Section 24(a)(6) that the *recognized* loss subject to disallowance in a single transaction is the net "loss from sales or exchanges," and not the component losses as held below, is further submitted logical in view of Article 23(e)-1, Regulations 94 which says:

> "Substance, and not mere form, will govern in determining deductible losses."

In other words, a loss from a single transaction must be recognized as substantial to be disallowed by Section 24(a)(6), and the Section hence does not disallow the component losses that affect the substantial and recognized gain or loss therefrom.

The necessity of treating a single transaction as a whole for a correct tax result, has been upheld in numerous cases.

In *Henry F. McCreery* [19] the contention that gain or loss respectively from the sale of good will and tangible assets of a partnership should be separately computed, because separately priced, is rejected on the ground that the intent was to sell and purchase the whole business in the same transaction. In *First Seattle Dexter Horton-N. Bank* v. *Commissioner*,[20] an exchange of preferred stocks and a sale of part thereof for cash are held only a single transaction, as the items were interdependent, and for simultaneous performance. In *Helvering* v. *Janney*,[21] this Court holds the computation of the joint net income of husband and wife requires the gross income and deductions of each to be aggregated and treated as the income and deductions of a single taxpayer. In *Bowers* v. *Kerbaugh-Empire Company*,[22] this Court holds a single transaction, involving payment of a debt in depreciated marks in a sum less than its original amount, will not be broken down into parts to define the amount saved as taxable income.

In another aspect, the error below is again evident. Section 24(a)(6), in its denial to designated taxpayers of "loss from sales or exchanges of property" as a deduction in computing net income, is submitted to mean no more than other Sections denying the deduction of insurance premiums, special assessments involving local benefits, losses not from a trade or business or not from a transaction entered into for profit, gambling losses, or amounts paid out for new buildings. Petitioner poses the denial imposed by Section 24(a)(6) is to be effective in the computation

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[19] 4 B. T. A. 967.

[20] 77 F. (2) 45 (C. C. A.-9).

[21] 311 U. S. 189, Cf. *Commissioner* v. *Thomas*, 84 F. (2) 562 (C. C. A.-5).

[22] 271 U. S. 170.

of correct net income, in the case of any single transaction, to the same extent that said other explicit denials have been made effective in established precedents.

Thus, this Court holds in *Lucas* v. *Alexander*,[23] an individual has net income only in the excess of the surrender value of his insurance contract over his premium payments, although such premium payments are expressly denied to him as statutory deductions.

Thus, although the form of two separate transactions is evident in a condemnation award of severance damages to the remaining real estate, and a special benefit assessment against the remaining real estate, this Court finds no objection to the offset of the assessment against the award as the correct computation of net income, notwithstanding that a special assessment is not a statutory allowable deduction.[24]

Thus, a "gentleman farmer", is not allowed any statutory deduction for "personal living or family expenses", nor for the losses from his "hobby" as it is neither "a trade or business" nor a "transaction entered into for profit". Notwithstanding his sundry items of farm income thus appear to be taxable net income, the Courts and respondent recognize his disallowance to be the net excess of his expenses and losses as offset by such income.[25]

Thus, prior to 1934, although the revenue laws did not provide for deduction of gambling losses to the extent of

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[23] 279 U. S. 573.

[24] *Carrano* v. *Commissioner*, 70 F. (2) 319 (C. C. A.-2).
Christian Ganohl Co. v. *Commissioner*, 91 F. (2) 343 (C. C. A.-9) (Cert. den. 302 U. S. 748).
Central & Pac. Inv. Corp. v. *Commissioner*, 92 F. 88 (C. C. A.-9).
Palladium Amusement Co., 37 B. T. A. 149. Respondent acquiescence G. C. M. 20322, C. B. 1938-2, p. 167.

[25] *Harry C. Fisher*, 29 B. T. A. 1041, affd. per curiam 74 F. (2) 1014 (C. C. A.-2).
Deering v. *Blair*, 57 App. D. C. 367, 23 F. (2) 975.
Union Trust Co. v. *Commissioner*, 54 F. (2) 199 (C. C. A.-6).

gambling gains as now authorized,[26] only the actual recognized income from gambling transactions was taxable.[27] Thus, in 1936, a person erecting a building at a cost of $10,000 and selling it for $10,000, obviously has no taxable income, but application of Section 24(a)(3), providing no deduction shall in any case be allowed in respect to any amount paid out for new buildings, in analogy to the decision below, would create a taxable profit of $10,000 from the sale.

These precedents point the confusion and absurdity if the interpretation below should be generally applied to the disallowance of deductions. They establish that taxing statutes cannot be interpreted as creating income where none exists.

If it be wrong to inflate net income because statutory deduction of the pertinent offsetting loss or adjustment is not provided, such inflation, by holding Section 24(a)(6), intends more than the disregard of a recognized statutory deduction, is equally wrong, and leads to the fantastic results previously stated.

A further plethora of authority establishes the doctrine that transactions intended as a unit are not treated as separable for tax purposes,[28] and, with those pertinently cited *supra*, definitely point the conflict produced by the decisions below.

The decision below has been shown to rest upon a decision involving an entirely different state of facts, and,

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[26] Internal Revenue Code, Section 23(h).

[27] *James P. McKenna*, 1 B. T. A. 326.
M. M. Frey, Jr., 1 B. T. A. 338. Respondent acquiescence, O. D. 42, C. B. 1, p. 124.

[28] *Pearson* v. *McGraw*, 308 U. S. 313.
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Helvering v. *Bashford*, 302 U. S. 454, 458.
Bassick v. *Commissioner*, 85 F. (2) 8 (C. C. A.-2), Cert. Den. 299 U. S. 592.

otherwise, is unsupported by precedent. The authorities cited in the Board opinion are equally inapplicable. The *Cooledge* decision [29] involves only the *quantum* of gain or loss not non-deductibility of loss, and supports petitioner because therein the separate computations of gains and losses were combined in a net result, a net gain as herein. The *Deering* [30] decision, to the extent rejected herein as *dictum* and to that extent sustaining petitioner, will be found upon careful examination to be a precise issue carefully decided in favor of the contention herein that the resulting net gain or loss from a single transaction, and not the gain alone upon any component part, is the proper computation; it further discloses *Deering* conceded the resulting net loss to be unallowable under 24(a)(6). The *Taylor* decision [31] involved only the application of a penalty provision, and not Section 24(a)(6).

Conclusion.

For the reasons stated, it is respectfully submitted that this petition for a writ of certiorari should be granted.

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[29] 40 B. T. A. 110.

[30] 40 B. T. A. 984; the revocation herein of dictum in this opinion overlooks such dictum is upheld by the previous ruling in John C. Moore (affirmed 42 F. (2) 186 (C. C. A.-2)) where the Board held transfers of lands and buildings for an annuity constituted a single transaction.

[31] 40 B. T. A. 696.